DOW THEORY LETTERS INC.

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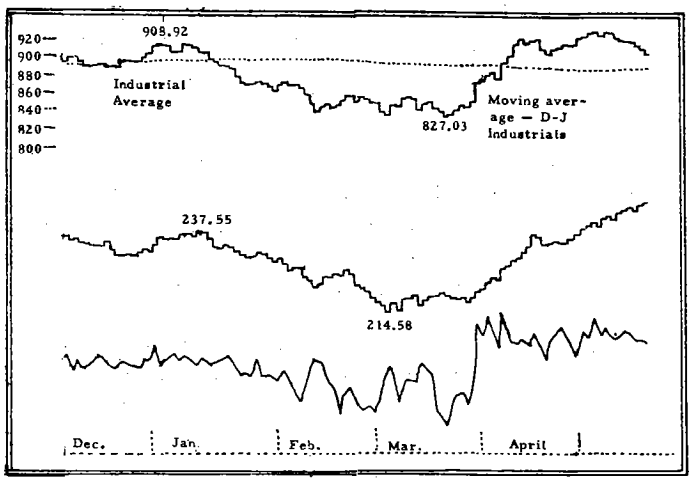
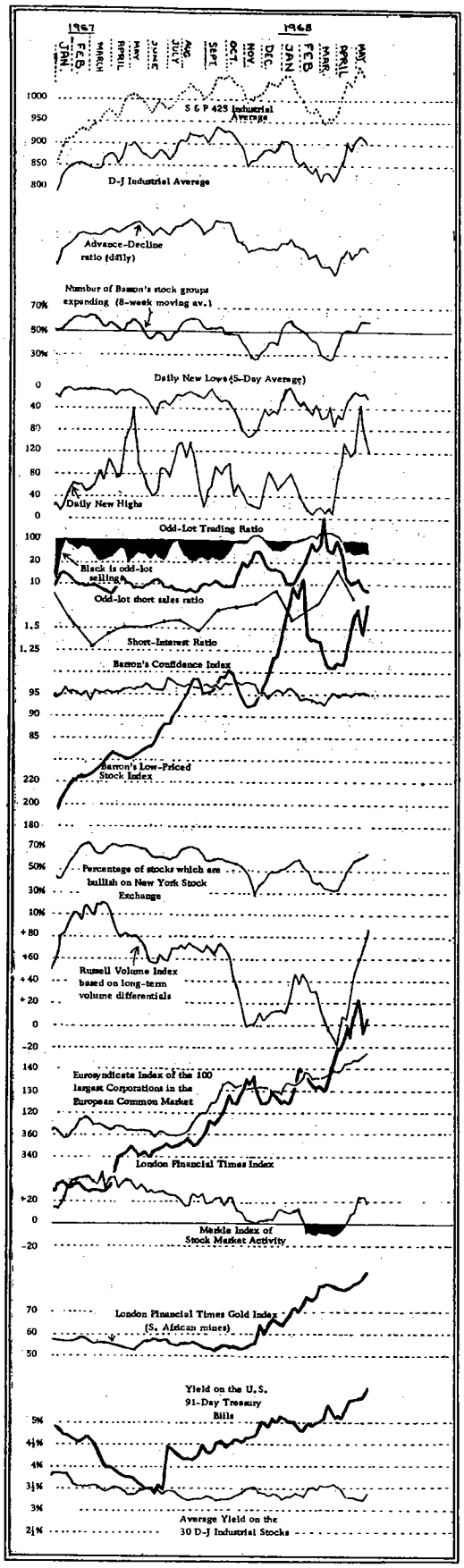
THE MARKET: The eyes of the world were on Paris and the "peace negotiations" last week, but one of the week's most interesting news items received considerably less publicity. This was the resignation of publishing magnate Cecil King as a director of the Bank of England with the statement that Britain is "threatened with the greatest financial crisis in our history." King charged the Government with "lies about our reserves," and in the face of this the London stock market dropped 17 points on that day while the pound sterling sank to a new post-devaluation low of $2.39075.

Subscribers to this service (who are well aware of the monetary and gold picture) have probably noticed not only the weakness of the British pound but also the steady climb of the South African Gold Index ("Kaffir Index") to above 86 and to within a few points of its earlier 1968 peak (which was the highest level since 1960—see later section of this Letter).

Meanwhile, from all quarters warnings are being issued regarding the trend of events in the U.S. Alfred Hayes, president of the New York Federal Reserve Bank, stated last week that "the dollar is.....in a condition of crisis.....and there is no conceivable excuse" for a $20 billion Federal budget deficit. Pierre Rinfret, leading economist, noted before the Security Analysts meeting, "I think that the U.S. and the rest of the world face the possibility of a repetition of the kind of economic environment that we had in 1928 and 1929."

My cohort James Dines believes that the U.S. has caught "the English sickness." This consists first of inflation, domestic expansion and full employment, then when international payment deficits become all too blatant, the Government is forced to raise taxes, cut spending, decrease the money supply. Right now we are in the midst of the cross-fire with Congress undecided on a surtax and large spending cuts, with the Federal Reserve Board thrusting the commercial banks into a minus reserve position while upping the discount rate for the third time. Finally, we have a President who wants the best of three worlds; a victory in Vietnam or peace at the negotiating table, an expanding economy, and a decrease in inflationary forces.




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 A cogent comment on the whole situation was offered by Elliot Janeway in his May 9 Janeway Service: "In terms of budget politics, the failure to achieve peace is preventing the Administration from achieving economies in the war budget. At the same time, the hope that peace will be achieved is opening the way for the expansion of expenditures in the cities. Disastrous though a 'more of the same' escalation would have been, it would have offered one consolation fiscally: it would have opened the way for the passage of a war tax. The opening of peace talks closes off this escape hatch for the Treasury. The war crisis seems close enough to being brought under control to make a war tax unnecessary; while the trouble in the cities is close enough to going backward to make spending on preventive programs inescapable."

* * * *

So much for some of the background which has developed during this latest rally in a primary bear market. As for the big picture, we are still in the deceptive second phase of a long-term bear market which began in February, 1966, following the historic 995.15 peak of that year. We must remember that overall, the pattern is still one of major declining tops for the Dow. The 1966 high of 995.15 was the primary peak. The second peak came in 1967 at 943.08. A third peak may now be forming in the 920 area, but it is too early to say for sure.

The short interest is still very large, odd-lotters have been selling, many of the funds have been buying heavily in an effort to get in on the rise. During the second phase of a bear market, it is normal for Wall Street to be buffeted by conflicting news and sentiments, and during the whirlwind of violent rallies and declines, almost everyone ends up confused and ultimately poorer.

Currently, we are witnessing the second rally since the 1967 high of 943.08. The first rally carried to the January, 1968 high of 908.92. A sharp decline took the Dow to 827.03 on March 5. The latest rally brought the Dow back to 919.90 on May 7. The fact that the recent recovery took both Industrials and Rails above their earlier peaks has caused many analysts and speculators to turn bullish. But I firmly believe that these gentlemen are going to be wrong if they think that a "new bull market" has started.

This is an election year, the President has stated that he will not run again, a vicious and expensive war is continuing despite negotiations, the reserve currencies of the Free World, the dollar and the pound, are under attack, the price of gold has been set free, interest rates are going through the roof, the U.S., Britain and most of the rest of the world are caught in a miasma of inflation, new spending priorities are being proposed in the U.S. as fast as thoughts of "spending cuts" can be conjured up, and the stock market is sailing into the vortex of one of the most news-filled and rumor-filled years in memory.

I want to stress one thesis again, and that is the ultimate, relentless power of the primary trend. In 1937 Robert Rhea wrote, "Dow's Theory pays no attention whatever to wishful thinking of industrial leaders as expressed in bullish pronouncements; it makes little of Presidential scoldings. The primary trend of business and stock prices cannot be 'talked up' or 'forced down' by the President, by Congress, or by any single man or group of men."

Rhea was, of course, referring to the long-term primary trend. He was not talking about secondary reactions, sudden minor or intermediate responses to news or overbought or oversold spots within a major primary or tidal movement.

I have noted that throughout history, when a primary movement has been held back or extended by some news event or series of events, the eventual resumption of the primary trend is particularly forceful. In the present situation, the bull market peak came in February, 1966. It is now two years and three months after the bull market top, but it is noteworthy that mass bearishness has never really hit this market. At the 1966 low the Dow was down 251 points from the bull market peak, but before this bear market breathes its last I would venture to guess that the Dow will be 500 or 600 points below the 995.15 high.

* * * *

From the standpoint of sheer common sense the following thoughts are worth mulling over. In the frontpage editorial of the Wall Street Journal (May 13) it was noted that "For almost a decade through 1964, prices had held remarkably stable. Then, in 1965, the unemployment level fell from 5% to 4%. And at the same time the price stability began to fade. Since 1965, the unemployment rate has been well below the 4% line almost all the time, and the rise in prices gains momentum. Retail prices have risen nearly as much in the last 12 months as they did in the three years ending in 1965."

This is all very interesting, but just as interesting is the fact that the Dow peaked at 995.15 in early 1966— at just about the time that this violent inflation swung into full force. Now 27 months later, the Dow is still below its 1966 peak. In other words, the gathering inflationary forces of the years 1966, 1967 and 1968 were unable to propel the Industrial Average to new highs. On top of this we have had the flight from money into securities, and this massive attempt at hedging and "protection" too has failed to take the Dow to new highs. Finally, it is reported that there has been a large movement of foreign funds (in the U.S.) into the stock market as fears of devaluation increase. But this money has also been absorbed without producing new highs in the Dow.

What does it all mean. To me, it means that very powerful forces are distributing stocks and have been distributing stocks since late-1965. These are the forces which turned the tide bearish. I am referring to the "big money" which consciously or unconsciously believes that the best has been discounted and that regardless of any amount of forthcoming inflation, price rises and money-printing, the top has passed. It is this battle which we are witnessing now, the forces which foresee deflation and trouble ahead vs. the forces that are betting on ever-increasing inflation to hold the market up.

At a certain point ahead, I would bet that we are all going to see what the big sellers have been sensing and preparing for during the past three years. The deep-seated, subtle, deflationary pressures are going to burst forth in clear view for all to view. And they are going to possess just as much power as the inflationary forces which the world has grown so used to over the last quarter of a century.

I wrote about deflation to some extent in the last Letter. Subsequently, Barron's (May 13) saw fit to grace their front page with an article entitled "Whiff of Deflation?" The article was sub-titled "Onward and upward won't be the watchwords forever." I strongly suggest that all my subscribers study the Barron's article carefully.

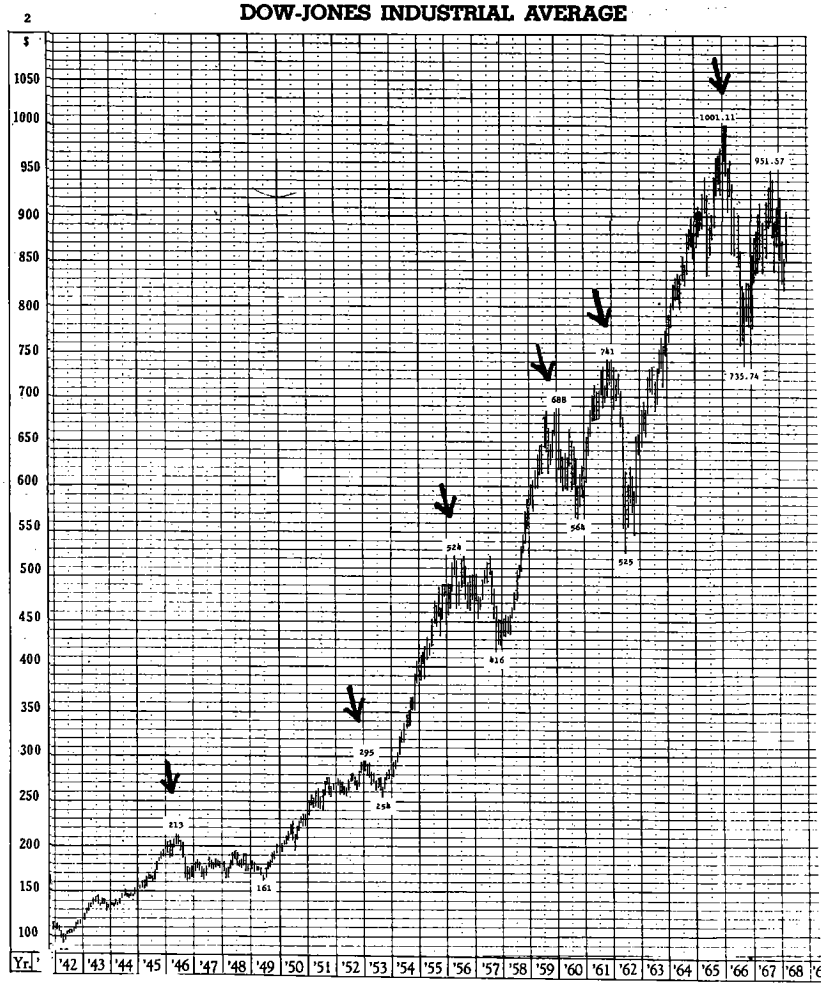
In concluding this section, I want subscribers to remember that the recent rise from the March low was one of the most emotion-packed and frenzied advances in New York Stock Exchange history. Volume on the rise broke all Exchange records. As a rule, when this much pure emotion accompanies a market movement, any dampening of hopes can bring on a reversal which is just as emotional. Therefore, if Wall Street and the public becomes disenchanted with the surtax hopes, the Vietnam negotiations, the monetary picture or all three together, we could see a decline which would be sweeping and highly emotional.

The most powerful (bullish) market movements, historically, have been the slow, plodding advances which are built upon sound but unemotional appraisals of what lies ahead. Such movements were seen following the 1949 bottom and following the 1953 low. The explosive advance which started at the March, 1968, low hardly fits this type of description. In fact, the recent rally was completely typical of the sort of rally one can expect periodically during a major bear market.

SOMETHING NEW: The accompanying long-range chart is well worth studying (chart courtesy of M.C. Horsey, Salisbury, Maryland 21801). Here we see the monthly high and low for the Industrial Average since 1942.

I have drawn six arrows on the chart. Each arrow points to a major market top or distribution area. These areas occurred in 1946, 1953, 1957, 1960, 1961 and 1966. In themselves, none of these tops were anything out of the ordinary. Markets go up, they form tops, and they correct or go down.

However, there is one phenomenon which is out of the ordinary in that it has not occurred before on this long-term chart. Note that following each market top there was a severe drop, then a rapid accumulation area (or bottom). Following the bottom the Dow Industrials marched with little interruption to new historic highs. The action following the 1946 top did provide a different formation. The year 1946 was followed by a real primary bear market, and the action from 1947 to 1949 represented a long period of re-accumulation prior to the major 1949 bottom. Note that the 1947 to 1949 action took place near the bottom of the decline. This is



typical of true bear market in that there was no bounce or immediate recovery following the 1946 crash. Stocks were accumulated slowly and patiently near the lows.

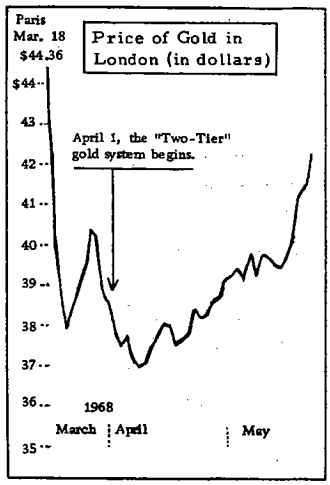
But starting with the 1949 low a new primary bull market was born. And following each correction during that bull market (i.e., 1953, 1957, 1960, 1961) the Averages turned violently upward and proceded to new highs in short order.

The bull market which started in 1949 ended in February, 1966. The Dow broke from the 1966 high of 995.15 to the 744.32 low of October, 1966. Then, instead of advancing to new highs, a second "toppy appearing" pattern was formed during 1967. It is important to realize that the big 1967 top occurred below the 995.15 high of 1966. Here, for the first time, the Dow Industrials failed to march to new all-time highs following a major (i.e., 1966) peak.

This phenomenon is what now gives this bear market the appearance of successive major declining tops. Actually, as seen on the chart, the 1967 top area is beginning to look larger and more ominous than the original 1966 top. From all appearances, what is happening is that stocks are being distributed again, but this time they are being distributed below the old 1966 highs. My guess is that following the current distribution zone, the true smash will come. In the meantime, the Industrial Average continues to whip back and forth within an area bordered roughly by 920 on the upside and 825 on the downside.

Robert Rhea wrote that during primary bear markets it is to be expected that major penetrations of trading zones will occur in the primary direction (i.e., in this case down). Time will tell.

GOLD: On May 14 the price of gold on the London free market pushed over the $40 level for the first time since the two-tier gold system was inaugurated. In response the gold shares ran up to new recovery highs, and the South African gold share index pushed well above 86 (see chart) to within a few percentage points of the recent peak.



Danger signals were flying on the money front, and as the price of gold continues to climb it is certain that either (1) money will have to be made still tighter in the U.S. to dampen the inflationary tide or (2) devaluation will be thrust upon us. It is well worth noting that at $42 per ounce, the free market is discounting the dollar at around 18%, and this in itself is an obvious free market devaluation of the dollar.

Ironically, the longer the world waits for devaluation, the higher the devaluation figure will ultimately have to be set. Dr. Franz Pick, leading world currency expert, now estimates that the U.S. gold position is at a new low. Considering the following deductions from official U.S. stated gold figures (1) gold borrowed from I.M.F. payable on demand, (2) bonds purchased by foreigners and having first priority on U.S. gold, (3) foreign currency loans guaranteed in gold, (4) other priority loans guaranteed in U.S. gold, considering all these Pick estimates that the U.S. now owns about $7.3 billion in gold.

In view of this shocking low in actual (or unclaimed) U.S. gold, a rise in the price of gold to $70 per ounce would be needed to provide the U.S. with $14 billions in actual gold reserves, while a rise to $105 per ounce would give the U.S. a $22 billion gold reserve.

Meanwhile, cohort Harry Schultz observes that there is some question about the purity of the remaining U.S. gold. If this proves to be true, a significant portion of the U.S.'s remaining $7.3 billion in gold may be unacceptable to international settlement or for commercial purposes. That is hardly a comforting thought.

Indicator Digest has uncovered the same story with U.S. silver, and it now turns out that aside from the official U.S. stockpile, there will be only impure (.900 silver) left in the Treasury for sale after all U.S. silver certificates expire on June 24. Since most commercial silver users require almost pure silver, the situation in this precious metal is explosive, and $3 silver is being freely predicted by many experts before this year is out.

With the gold-silver picture literally ready to blow up in the face of the U.S., the money market is thinking in terms of higher interest rates and a halt to speculation in perhaps the final Administration effort to stop the precious metal flow. At last Monday's auction the bellwether 91-day U.S. Treasury bills sold to yield 5.67%, highest yield level since late 1966. During the same week Moody's AAA Corporate Bond Average rose to an average yield of 6.25%, a new peak for 1968. The little clip on page 5 from the New York Times documents the gathering storm on the money front.

But the gathering storm is not confined to the U.S. alone. Far from it. Latest figures show that the British trade balance is running at a totally unsustainable deficit level of $2.4 billions, a horrible situation when measured against

Britain's thin reserves. If a second devaluation of the pound occurs (and it is highly likely), there are few who believe that the dollar will be able to hold. Said the editor of the Weekly Bond Buyer (Charles Brophy) last week, "Responsible Swiss bankers, according to money market partners returning from Europe, are predicting the dollar will be devalued in six to nine months as part of a general devaluation which will allow a more extended devaluation for the dollar in order to align U.S. goods in world markets on a competitive basis."

Meanwhile, though few are aware of it, Canada (like South Africa) has been purchasing all newly mined gold from its mines. This means that the gold output of both Canada and South Africa are being withheld from world markets. This procedure on the part of two governments is tending to force the price of gold higher. When Canada and South Africa do decide to market their gold output, it is not known whether they will sell part or all to the free markets (or whether part will go to the various central banks to build up dwindling reserves.

* * * *

Last week rumors were being heard regarding a break-up in the agreement by central bankers not to buy additional gold. As dollars pile up in central banks, the appeal of South African gold at the old $35 per ounce price becomes more and more attractive, and as this news clip suggests, it may be just a matter of time before the whole U.S. gold "policy" is in shambles. On May 20 the price of gold (see chart) at London closed at $42.30, a record high. Volume in gold trading was beginning to expand rapidly. The final, fateful gold run could be underway.

* * * *

I have been warning against undue optimism regarding the surtax and regarding negotiations with Hanoi. Both of these situations will place continuing severe pressure on the dollar unless they are solved successfully. Now the surtax bill has been put off until June because of the political problems inherent in a $6 billion cut in spending. If the bill is defeated, it will be defeated on the basis of the unacceptability of spending cuts, not on the basis of higher taxes. Rumor has it that LBJ himself mustered the liberal forces which put the bill off until June. If so, the President has pulled a "monetary Vietnam."

As for the negotiations, I continue to believe that these will be more difficult than anyone imagines. I include this paragraph from an article by one of the most accute observers of the Vietnam scene, 1964 Pulitzer Prize winner David Halberstam (article from the May 11 New Republic): "I mention this history because it bears on my judgment that peace is not likely to break out this year, and that its achievement will be far more difficult than even the most pessimistic columnists appreciate. The enemy is not only convinced that he has won the war; he has the passion, the resources, and I suspect, the desire, to continue the war until he gets exactly what he wants. He will come to peace talks remembering with bitterness what happened at Geneva 14 years ago. We may imagine that somehow we gave in to the communists there in 1954. They feel they were about to take the entire country, and were cheated out of it. They are not about to settle for very much less; and, I suspect, given their control of the population, they will be willing to keep the war going until they get what in essence is victory."

* * * *

From all I read (and I read plenty), only astute economist Elliot Janeway has noted the supreme LBJ blunder

BOND RATES SET NEW HIGHS AGAIN

More Fixed-Income Issues Are Offered and Quickly Bought by Investors

UTILITY COST IS 6.7656%

$100-Million for California Placed at Fifth of a Point More Than in January

By JOHN H. ALLAN

Interest rates continued to reach record highs yesterday as a large number of new fixed-income security issues were marketed. Investors, spurred by Congressional action on the tax increase, quickly bought most of them.

Gold Breaks $40 Barrier

Compiled from The San Diego Union's News Services

LONDON — The price of gold yesterday broke through the psychological barrier of $40 an ounce. Dealers said trading was calm.

Ever since the gold market was unhitched from monetary gold supplies at $35 an ounce in mid-March, financial experts have been watching it as a barometer of confidence in paper money. They felt that when the free market price touched $40, there might be some temptation for central banks of smaller countries to feed in monetary gold and take a profit.

The market has been rising steadily since U.S. Federal Reserve Board Chairman William McChesney Martin warned of a new financial crisis.

Gold closed at a record $40.25-$40.50 an ounce in Zurich and at $40.24 in Paris. The U. S. quote was $40.70.

In London, meanwhile, the premium British investors must pay for funds to invest overseas reached 48⅞ per cent. Market sources said more British investors are looking abroad because of uncertainties in sterling.

EUROPE WEIGHS RUMORS OF GOLD

Some Nations Said to Be Seeking South Africa Gold

By CLYDE H. FARNSWORTH

Special to The New York Times

BRUSSELS, May 6 — As the gold price mounted today to within a shade of $40 an ounce, rumors persisted that central banks from one or two Western European countries were considering acquiring gold directly from South Africa.

European central banking sources did not dismiss the idea out of hand. If such acquisitions are made, it could weaken the Washington central bankers' accord of March 17 and the new two-tier gold market.

The rumors began in Switzerland late last week. According to Zurich bankers, the South Africans were planning to sell 400 tons of gold to central banks at the official price of $35 an ounce.

of meeting (for negotiations) in Paris, rather than Warsaw or someplace else. Russia and France both have an interest in a higher gold price, Russia because she is a supplier, France because she is a big holder. With the negotiations in Paris and with Russia and Paris now in a position to pull many strings, a higher gold price can be used as leverage if the U.S. refuses to buckle down to Hanoi's terms. "Settle on our terms and we'll take pressure off the dollar," could be the watchword from the Communist world, "Hold fast and watch the war continue and the price of gold push into the blue yonder." Never, in this observer's opinion, has a leading power's weak monetary position so militated against it in its goals.

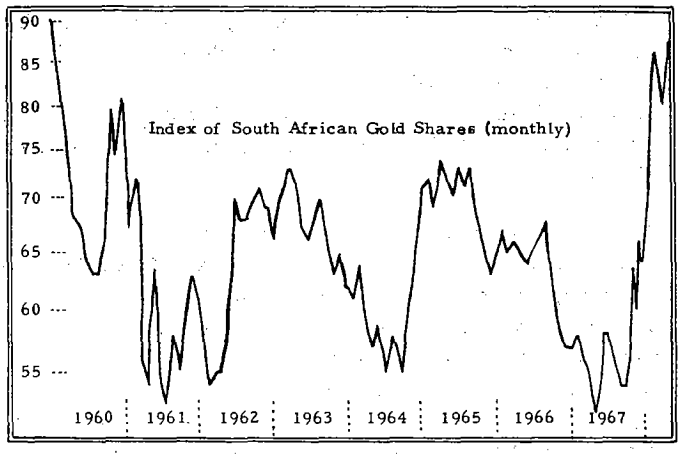
"Who has the gold has the power," runs the old adage. For years our Government has spit in the face of this adage. Now there is an excellent chance that they will learn the truth about the power of gold—the hard way.

DOW THEORY MARKET LABORATORY PAGE

I sometimes ask myself whether subscribers will think I have anything to write about when the final gold crisis blows up and blows over. The answer is that there will be plenty to write about, but right now the big and "getting bigger" story continues to be gold.

The bottom chart shows the standing of the Gold Group compared with the other 89 Standard & Poor stock groups (statistics compiled by Chartcraft). Note that the steady rise in the Gold standing during 1966 give early warnings of the first gold crisis. The second rise in 1967 offered the same warning. Following the late-1967 and early-1968 standing of number one for Golds, the Group dropped back to number 30 position. Then instead of breaking down as in late-1966, the Group standing rose again to last week's high position of number 8. I would guess that gold will be back in the number one spot during the next month, and this (if it occurs) is saying "danger" for the general market.

The top chart shows the index of South African gold shares, and if there is a subscriber who does not hold a position in Blyvoors, Free State Geduld, Western Deep, President Steyn, President Brand or American South African it is not my fault. I have been talking my readers into them for the past three years.



On May 20 this index closed at its highest price in eight years, thereby indicating a steady movement of international money into the hedge-safety of the world's leading gold equities. Since South Africa can and will probably sell gold on the free market, the current free market $7 premium over the old $35 price will mean improving profits—even before official devaluation.

All the listed gold shares are now in bullish trends, and based on its point-and-figure work, Chartcraft gives the following "price objectives" for golds. Amer. South African...88, Campbell Red Lake ....58, Dome....86, Homestake....113. Obviously, there is no guarantee that these "objectives" will be hit, but golds are, and have been, in a primary bull movement. Often, primary bull movements take stocks beyond the minimum point-and-figure counts.